DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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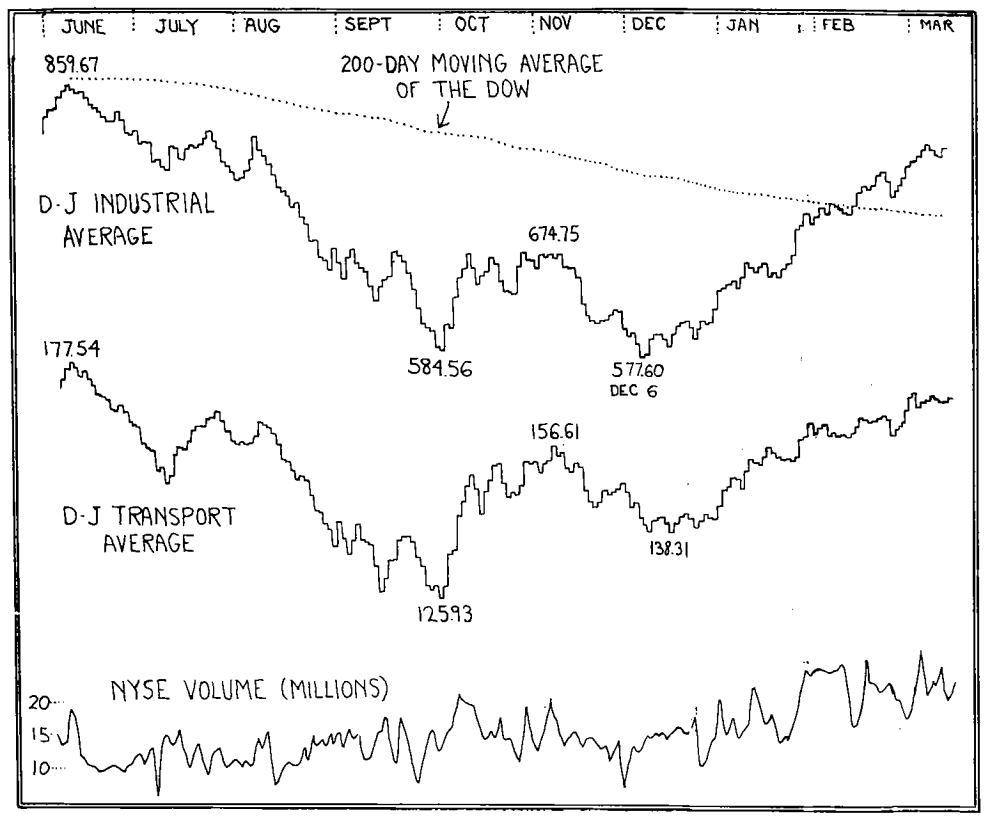
THE PICTURE: Well, who would have believed it? In the last week US purchasing agents reported that for the first time since 1963 the cost of raw materials is coming down. Fortune magazine, in its widely-followed "Business Roundup" column, headlines the March issue, "The End of the Decline is Now in Sight." And not to be left out of the act, the Phillips-Sindlinger Survey (which was seeing all sorts of ominous scenarios only a month or so ago) now reports that between early January and February 19 the percentage of households with consumer confidence climbed from 22.4% to 39.1%. That was only February, and I imagine March should look even better. Then last week the Government announced that retail sales (dollar volume) were up in February for the third month in a row. Finally, inventories are coming down. At this rate the outfits that sell all that evaporated "survival food" will be trading in their franchises for Big Mac stands (if you live in the West try a Taco Bell).

Nevertheless, the stock market (as usual) is totally heartless. It has been grinding the bears to a pulp, squeezing them, torturing them, offering them tidbits such as a reluctant Utility Average, a selling spasm every morning at the opening, a lack of odd-lot shorts, a dozen little technical items to encourage them. Yet the primary trend of the market, the tidal force (comparable to the tide of the ocean) continues to come in. Having been fed on a steady diet of worry, the bull market has now reached the point where the analysts (based on past precedent) can reasonably warn that "it's gone too far too fast" or that "if it doesn't correct soon it's going to collapse."

And based on simple past precedent, anyone would be prudent and well within his rights in insisting that this market "should" now correct. I've reminded subscribers on dozens of occasions that every market movement (minor, secondary or primary) is subject to the normal 1/3 to 2/3 correction. But when is the problem, not whether.

Frankly, I must confess that I've never seen such unanimity of opinion as the one now calling for a sizeable market correction. It's absolutely remarkable that the advisory services, my correspondents, callers, everyone is acutely aware of the coming fall. If they're right, I'll take my hat off to them. Personally, I've always found the secondary correction in a bull market rather difficult to call, but then maybe there are more smart people around today than there were in the 1950's or '60's.

I'll have more to say about the intermediate picture shortly. But the real argument around the country is not whether this market is about to fall on its fanny near-term, it's whether this is a primary bull market at all. Make no mistake about it, there is a large body of professional opinion that is denying, ridiculing or stubbornly arguing with this bull trend. I know because I read a great number of these reports each week. Actually, I do more than just read what the bears are saying. I probably put more study into the bearish reports than I do into the bullish ones. Why? Because I find it particularly instructive to read what those who disagree with me are saying. And it helps me to try to see where I might be going wrong. Secondly, since the bears have been wrong so far, I read them because I have found that I learn a great deal from both my own mistakes and from the mistakes that other men make. I like to learn why and how we make mistakes and hopefully to avoid those mistakes in the future.



 I would say that in general, the bears can be divided into two camps. (1) Those who were not satisfied with the market bottom of 1974 because it did not meet their requirements and expectations. This group wanted lower prices, lower volume, higher yields, greater pessimism, etc. Since they didn't get their prescription filled in 1974, they insist that the "real bottom" lies ahead following this "fake rally." (2) The second camp insists that the current fundamental situation in the nation is a formula for disaster (they are talking about the debt, the monetary situation, interest rates, etc.). They feel that the market has no right to be going up now, but since it is going up, it's all an absurd mistake, and the market will therefore go down "bigger" than ever during 1975.

My answer is that either or both groups may be long-term correct. But if they are correct, they are nevertheless wrong on their timing. The 1974 bottom may have been a false one, the Dow Theory bull signal may have been a false one, the rise from 577.60 to the upper 700's may have been a false one, but from letters received here I note that many of my readers have garnered profits (both paper and realized) of 50% to 100% on stocks they purchased, and those profits are not false ones. Furthermore, if the market now consolidates or continues to push higher, the position of the bears will become increasingly untenable. They will lose their psychological market balance, they will be leaning more and more on hopes and wishes, they will find themselves cursing the "Wall Street idiots," cursing the "pathetic optimists" who have been buying, cursing the "crazy market" itself. The fact is that being on the opposite side of a major market movement throws you off on your thinking. And once you are off balance, it is extremely difficult to get repositioned again, to get all your "investment marbles" back in the right places.

I hope I'm not an utter fool. If I'm not, then I will be able to suggest taking profits, moving to the sidelines, even cleaning out when the situation looks dangerous enough to do so. In the last Letter I did advise caution, and I did advise a little of that exotic practice known as "taking a few profits." I also said that the best buying is done while sweating, and that I felt we were entering the area where a bit of greed was taking over from the December-January period in which we all perspired profusely as we bought.

I know that the odd-lot public has been on the sell side of this advance from the beginning. Selling reached a peak during late-February as the market dipped. During March the odd-lotters have been selling about 16 shares for every 10 purchased, and my reading of the whole picture is that the public remains skeptical about this market, but less skeptical than they were last December when odd-lotters were selling about 18 shares for every 10 bought.

More recently, I feel that a good many of the traders and "pros" have been getting worried about the duration and particularly the extent of this advance. Many are shorting the market, others are shorting against long-term positions (betting on a short-term decline) or against longer-term option holdings. I will be most interested to see the March short interest totals, and these figures may tell us more about the prevailing market psychology than anything else.

Remember, at the last reading (mid-February) we had over 25 million shorts on the NYSE. In order to make money, the shorts need real downside action. This usually entails lower prices on increasing volume. But when a bull market backs off grudgingly on contracting volume, the shorts get that old choking f e e l i n g — known in market parlance as the "squeeze." So far, that is what has been happening. This market makes noises as if it is going to swoon, then volume dries up, the A-D ratio gives a little, and, and ... nothing. No downside follow-through materializes. Result: the shorts are pressed against the wall; it's "Squeeze City" on Wall Street for the bears — which is bullish for the market.

The index that measures the above-described action is the short interest ratio, a ratio that I pay close attention to only during bull markets (in a bear market the shorts are correctly aligned with the downward trend). All areas of high volume (such as this one) are ultimately followed in bull markets by periods of rest, areas of low volume. When that occurs (and it will), we will probably get our first high reading on the short interest ratio (the ratio is simply the total short interest on the NYSE divided by average daily volume). Any time volume drops to around 14 million shares, we will have a SI ratio reading of around 1.8 which is bullish. If we get a low volume area of around 12 million shares a day, the ratio will rise to 2.0, which will make breathing exceedingly difficult for the bears.

NEAR-TERM: From the standpoint of Dow Theory, the last peaks for this primary bull swing were recorded by Transports on March 3 at 168.02 (see chart on page 1), and for Industrials on March 10 at 776.13. Thus, the last joint peaks occurred on March 3. After seven trading days of downside action, my observation is that the decline was notable only for its mildness. However, for newer students I should restate the rule that the first decline in the Averages is seldom very informative. It is the action of the Averages following the first decline that begins to spell out the story. If the Averages now push to new recovery highs we will have another "all clear signal" under Dow Theory. Remember, however, that every bull swing in the Averages provides a number of dips, each followed by a rally to new highs. Ultimately, there must be an upside confirmation that will represent the last one for that particular bull swing. We have had seven upside confirmations in the Averages (each following a minor dip) since the December lows. Obviously, each upside breakout is a little less valid than the last one — which is just another way of saying that the risks increase as a bull movement climbs "higher and wider."

The action of the Primary Trend Index (PTI) and the advance-decline ratio may be of help here in gauging this market. The PTI hit a recovery high of 281 on March 10 (see chart page 3). It is worth noting that since December the PTI tends to go up easily, but it declines grudgingly — which is exactly the opposite of its action during 1973-74. Following the March 10 peak of 281, the PTI slid to 273 on March 12. Two trading days later, on March 15 (Friday) the PTI was back at 280, one point from its high. That can hardly be termed weak action.